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EMPIRICAL RELATIONSHIP BETWEEN CAPITAL BASE AND PROFITABILITY OF DEPOSIT MONEY BANKS IN NIGERIA: A COMPARATIVE STUDY

Okpala Kenneth ENOCH [1]
Olagunju ADEBAYO [2]

ABSTRACT

The research work attempts to assess the relationship between capital base and profitability of deposit money banks in Nigeria. The research analysis used published audited accounts of seventeen (17) out of twenty-five (25) banks that emerged from the consolidation exercise and data from the Central Bank of Nigeria (CBN). The research denotes year 2003 to 2005 as the pre-consolidation and 2006 to 2008 as post-consolidation periods for our analysis. Data used for the work were collected from both primary and secondary sources. The two hypotheses formulated were tested using regression analysis and correlation co-efficient (r^2)*. The result of the analysis revealed that there is no significant relationship between pre and post mergers and acquisitions capital base of commercial banks and level of profitability. Based on this finding, it can be concluded that consolidation exercise through mergers and acquisitions has not improved the profitability performances of banks significantly. Finally, the study recommends that to generate more profit, the bank need a good regulatory environment that will enable them to expand their scope of businesses but strictly within the financial service industry; the government should provide necessary infrastructure in order to reduce the cost of doing business to allow banks to make profit.*

Keywords: Consolidation, Capital base, Profitability, Mergers and acquisitions

INTRODUCTION

Over the years, reforms have been a regular feature of Nigeria banking system as evident from the history of development of banking in Nigeria from the era of free banking 1892-1952 to the era of Guided Deregulation 1995-2004. Due to the rise in the number of the distressed banks which has

[1] Redeemer's University, Mowe, Ogun State, Nigeria, Email: kenenoch@yahoo.ca

[2] Redeemer's University, Mowe, Ogun State, Nigeria, Email: olabayo2012@yahoo.com

increased public awareness of troubles in the banking sector, investors and government have become very disturbed (Demirguc-Kunt and Levine, 2000; Osamwonyi, 2002). More so, when one considers the huge financial resources trapped in distressed banks. In order to avert a collapse of banking sector and ensure that the banking industry remains safe and sound, the monetary authorities introduced a number of strategies to turn around distressed banks, one of the strategies adopted is to increase the minimum paid up equity capital for all the commercial banks to twenty five billion (₦25b). This and other sanitizing measures are aimed at averting the problems. In a bid to satisfy monetary authority condition, banks resulted to merging with one another and acquiring one another. Soludo, (2004) affirmed this by saying that mergers and acquisitions strengthen the banking system and ensure a diversified, strong and reliable banking sector which will guarantee the safety of depositors' money, play active developmental roles in the Nigeria economy, and make the sector to be competent and comparative players in the African region and global financial system (Osho, 2004). Empirical observations by Soludo (2004) and Garba (2006) show that mergers and acquisitions are sine qua non to the economic growth and development in Nigeria; they averred that investment in economy is a function of trust and confidence which requires a strong, transparent, viable banking and financial sector. Garba (2006) further said that a financially weak banking characterized by poor capital, frequent distress, primordial and nepotistic ownership structure, poor investment culture and feeble laws can neither command trust nor confidence of both foreign and local investors.

Ngama (2006) posited that the problem with current minimum capital requirement is that it is consistent with but not sufficient to meet all, the four objectives that the Government sets to achieve which include limiting the moral hazards of investors, buffer against potential losses in the event of economic slowdown, make the bank very easy to sell in event of bank failure and forced banking mergers with strange bed fellows serving a fragile economy. The author added that the presumption that consolidation will ensure safety is faulty. He argued that a bank's size is a function of the size of the National Economy, the age of the bank and its branch spread. Soludo (2008) lending credence to the opinion of Ngama held the belief that the health of Banks depends on the level of its corporate discipline, its credit culture, its operational efficiency and its management information system. Soludo concluded that any big bank that fails to develop these attributes of a healthy bank will sooner or later fail. Extant literature shows that previous research work on mergers and acquisitions like those of (Okpugie *et al.*, 2005; Osho, 2004 and Amedu, 2004) concentrated only on the problems and prospects of mergers and acquisitions of commercial Banks in Nigeria. Hence, possibly the empirical finding substantiating the relationship between capital base and profitability of money deposit banks in Nigeria is unavailable. Therefore, the study seeks to assess the relationship between capital base and profitability of money deposit banks in Nigeria pre and post mergers/ acquisitions(through an empirical research study) in order to form an opinion as to whether consolidation exercise through mergers and acquisitions have a bearing on the profitability performance of the money deposit banks in Nigeria (Ailemen, 2003). The major objective of this study is to analyze the relationship that exists between pre and post - mergers/acquisitions equity capital base and profitability of commercial banks in Nigeria. The following research propositions were formulated for this study: H_{01}There is no significant relationship between banks' pre merger equity capital base and banks' profitability. H_{02}: There is no significant relationship between banks' post merger equity capital base and banks' profitability.

REVIEW OF RELATED LITERATURE

Factors driving mergers and acquisitions: Academics and other observers advance value-maximization, managerial ego, mimicry, the need to reduce uncertainty and defensive considerations (acquire to avoid being acquired; ensure that growth keeps up with that of competitors, etc.) and high levels of corporate reserves and share valuations among the motives behind consolidation in financial services (Ailemen, 2003). Supporters of M&As allege that it facilitates synergy between merged organizations, generate efficiency improvements and increase competitiveness. Indeed, they hold that mergers, by increasing economies of scale and spreading costs over a larger customer base, enable financial operators to provide services at lower prices. Demonstrating that M&As improve efficiency is thus central to making the case for the consumer benefits of mergers and in assessing their potential impact on consumers. If mergers improve efficiency, then larger, combined firms may be expected to pass some savings on to consumers through lower prices or improved services. If mergers are primarily cost-cutting exercises, involving job cuts and branch closures, the impact on consumers is most likely to be a lowering in the quantity and quality of services; individuals are affected by branch closures in rural regions and low-income urban neighborhoods and have to bear the brunt of a generalized decline in quality resulting from reduced effort in certain product lines or service modes (e.g. teller service, cheque-cashing, transaction and other basic services). Those opposing financial sector M&As strongly contest their consumer gains and maintain that they only result in employment loses and diminishing access to services, Claims that small businesses-generally agreed to generate most employment worldwide-also benefit from mergers have met with considerable skepticisms among those businesses themselves. Studies have indeed revealed that larger financial institutions tend to charge more and higher fees than their smaller counterparts and note an inverse relationship between the sizes of financial institutions and their loan portfolios to small businesses (Okpugie *et al.*, 2005). Assertions that size generates economies of scale essential to compete in global markets have similarly been disputed on the grounds that size is irrelevant to international competitiveness and cross-border mergers (so far rare among financial M & as outside the Nordic region) would be more logical to international competitiveness. It has been argued from a pro-merger perspective that, rather than size problems, banks have "excess capacity in their domestic markets, which drives up their costs, making them uncompetitive both domestically and internationally". According to this argument, mergers enable rationalization of networks and associated cost reductions. Whatever the arguments, many countries' competition policy in the financial sector is tending towards an easing of regulations and the elimination of obstacles between different market segments to promote greater competition among financial institutions. A paradox of these policy changes is that they seem to be encouraging concentration and formation of oligopolies, rather than increased competition, although the ability of technology to lower entry barriers to new types of financial service providers somewhat reduces the power of concentration.

United States and European case studies suggest that despite the fact that M&As in the financial industry may be partly driven by potential efficiency gains, managers, and governments, who appear to have more influence over consolidation decision for financial institutions than for non-financial firms, may have other motives (Alashi, 2003). Empire-building is included among possible non-value-maximizing motives given that executive compensation tends to increase with firm size, although part of the higher compensation of managers of larger institutions rewards greater skill and outcomes. Banking organization may overpay for acquisitions when corporate governance structures are insufficient to align managerial incentives with those of owners; what is more, management teams with large ownership stakes often block outside acquisitions. Many financial executives argue that preventing consolidation and the efficiency gains M&As make possible would be tantamount to forcing enterprises to engage in "social policy" through retaining unnecessary levels of employment and preserving distribution outlets that would be redundant in the event of a merger. They therefore believe that M&As are part of necessary restructuring to improve efficient use of resources-which can only be beneficial for long-term employment. But opponents stress the fact that financial sector operators lack transparency and accountability with respect to the social and economic impact of sectoral consolidation (Alashi, 2003). They argue that privately owned financial institutions perform essential public functions and so government regulation is the corollary of the rather privileged and profitable positions these companies enjoy. In most countries, the scope of regulation relative to M & As is narrowly focused on financial probity and competition issues; however, in some countries- such as the United States –a degree of socio-economic accountability exists. The Community Reinvestment Act (CRA) provides benchmarks under which bank performance on loans, investment and consumer service is measured whenever banks apply to expand their operations. Critics of mergers among financial service companies believe that an adaptation of this approach is needed to ensure consideration of the employment effects of organizational changes and to enhance transparency and accountability. Similarly, systematic tracking of banks' transactions with the small business community may now be timely.

CHALLENGES OF BANK CONSOLIDATION

According to Adeyemi (2006), the challenges identified in this research work cut across the banks, their shareholders, bank employees and other stakeholders in the banking industry. It is an established fact that the route to improving efficiency in any industry is to foster competition among the operators. This is evident in two important growth sectors of the Nigeria economy-aviation and telecommunications over the last one decade. A major challenge of bank consolidation is how to foster competition with fewer mega banks. Certainly, fewer cannot be more competitive. There is however, the other side to the argument, which considers the number and spread of bank branches. The fewer banks are likely to be pressured to expand further, seeking business opportunities through aggressive branding to hitherto unexplored territories (Hughes *et al*. 1998). There is ample evidence that this is the direction that the emerging banks in Nigeria are likely to follow, going by the indications in their capital raising information memorandum. International evidence in bank consolidation also confirms this except that it is more in the context of cross boarder acquisitions (Hughes *et al*., 1998).One of the supposed benefits of consolidation (Bigger Banks) is indeed and efficiency challenge. The argument has been that bigger banks might not necessarily be filter or more efficient, since they have no incentive to improve efficiency within the limited competitive field. Observers of Nigerian banking have noted that the big banks (perhaps because of the increase in the number of customers) have slipped back to their erstwhile habits before the advent of the new generation banks available empirical evidences from Hughes *et al*., (1998).

Another major challenge of consolidation is capacity building for risk management for both the regulators and operators. Both constituencies of the bank system need to enhance their risk management skills and indeed acquire new ones, covering the three plant of risk recognition, evaluation and monitoring (Adegbite and Carew, 1989; Lemo, 2006). These challenges which include among others: the down side of that is the likely inadequacy of qualified and experienced hands on ground with the result that qualified hands are increasingly on demand and with attendant high staff mobility and corresponding operations instability (Adeyemi, 2006). Additionally, many Nigerian banks are now opening off-shore branches to make impact beyond the borders of the country. There is the need for banks to acquaint themselves with the prevailing laws and regulations guiding banking in those countries and endeavour to always operate with decorum within the bounds of those laws and regulations so as to ensure that their operations do not bring a bad name to the country. The Nigeria banker operating abroad has by implication become a formal ambassador of our country (Agbaje, 2008). The author observed that the challenge of human capital development has become very pronounced with the emergence of mega-banks. Banks have the challenge of subjecting their staff to necessary training and skills development for them to cope with the demands of current level of activities in today’s banks in Nigeria. Beside the challenge of inadequate of skilled manpower, the availability of increased funding to mega-bank has given them the freedom to source more sophisticated operational facilities and that on its own has created new skills gaps in how to operate them (Afolabi, 2004). There is the increasing challenge to ensure good corporate governance in the banking industry in order to continue to sustain the confidence of the banking community, both locally and internationally. That is also necessary to ensure sustainability of the growth potentials. It is obvious that a failed post-consolidation banking industry will have very far-reaching implications for the national economy. The present gradual stabilization of key macro-economic variables in the economy notably, interest rates, exchange rates and inflation rate is a salutary development and that underscores the need for the regulatory authorities to remain on their toes to ensure the sustainability of and even improvement of such a development. The issue of dare-devil armed robbery attacks on banks appears to be on the increase since the emergence of mega-banking. This is not surprising since these robbers believe that banks will now be warehousing large amounts of money in their vaults. Although it is aware that the Bankers Committee, under the direction of the Central Bank of Nigeria has kicked off a preventive and defensive initiative, a tripartite solution to this problem requiring that banks, the police and Governments come together to evolve result-oriented strategies that will be enduring over time should be put in place (Lemo, 2006). Although the minimum capitalization segment of consolidation of the industry has since been achieved, the necessary mergers/acquisition/buyouts that ensued have thrown up some challenges which include, but not confined to, integration of the systems, human resource issues, equipment nature and maintenance, core values, corporate culture, etc, of the various banks in consolidated group. A poor handling of any of those integration challenges could spell disaster for the affected group, the industry and the national economy limited.

PROSPECT OF BANKS AFTER CONSOLIDATION

According to Uremadu (2007), the initial public offering by banks through the capital market when completed is likely to increase the level of financial deepening as evidenced in the upsurge in the volume and value of trading in stock market (ii) The reform in the banking industry has been able to attract more foreign investment inflow, especially in the area of portfolio investment; this development if sustained will boost the level of economic activity especially toward non oil sector (iii) The consolidation of banks is likely to attract a significant level of foreign banks entrance into Nigeria which will become a feature in the industry over time. This will bring about more confidence by the international community of the banking sector thereby attracting more foreign investment into the country. As the level of financial intermediation increase, interest rate is likely to fall and increase lending to the real sector that will generate employment and booster growth.

THE CHARACTERISTICS, ROLES AND GENERAL TRENDS OF FINANCIAL SERVICES SECTOR

Financial services support employment in two ways: as a source for a high-quality employment and through a pivotal role in providing credit to other sectors (Adeyemi, 2006). A well-functioning financial sector is essential in financing the operations of an economy through both intermediation (borrowing money from one sector to lend to another) and through auxiliary services such as securities broking and loan flotation. The financial system in any country has three overlapping components- financial enterprises (such as banks) and regulatory authorities; the financial markets (for instance, the bond market) and their participants (issuers and investors); and the payment system –cash, cheque and electronic means for payments-and its participants (e.g. banks). The interaction of these components enables funds for investment or consumption to be made available from savings. The institutions, services and products that comprise the financial sector vary from country to country, but generally include: the central bank; depository organizations such as banks, building societies or mortgage banks; general financiers; cash management firms; and others engaged in financial intermediation. The last category might include securitizes, investment companies, hire purchase and the provision of personal and consumer credit (Ewubare, 2004). In some instances, a wider perspective needs to incorporate not only the finance sector but also the business services that support its operation.

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Bank for Reconstruction and Development, says that "in 20 years, there will be no more than four or five global firms in each sector. Alongside, there will be millions of small temporary enterprises subcontracted by the large ones". David Komansky, CEO of *Merrill Lynch,* also believes only six to eight global banks will soon be competing on the world's financial markets, with regional entities, notable in Europe and Asia, existing side by side with these big international players. Others believe M&As will continue, given that companies restructure for various reasons including poor performance or changes in business strategies. Rapid Internet development makes medium-term predictions regarding the nature and phase M&As in the financial services particularly risky as technology is increasing the ability of newcomers to contest certain "niche" markets and intensifying the competitive pressure that are contributing to sectoral consolidation.

METHODOLOGY

The study adopted the homothetic methodological paradigm to give its entire process the empiricism and quantitative data analysis needed in scientific research. The audited accounts of seventeen banks were the main source of secondary data analyzed in this study. The hypothesized statements were tested using regression analysis and correlation co-efficient (r^2) statistical instrument. Regression equation Y=a+b x Where: Y=Department variable and X=Independent variable

$$b = \frac{(\sum xy) - (\sum y)(\sum \mathrm{x}}{\mathrm{n}(\sum \mathrm{y}^2) - (\sum \mathrm{x})^2} \quad ` \; a = \frac{\sum y}{n} - b\frac{\sum x}{n}$$

Correlation coefficient (r^2) = $$\frac{N\left[\sum xy\right] - \sum \mathrm{x} \sum \mathrm{y}}{\sqrt{\left[N(\sum x^2) - (\sum \mathrm{x}^2)\right]\left[\mathrm{N}\sum \mathrm{y}^2 - (\sum \mathrm{y})^2\right]}}$$

Where: X=value in the one variable. X^2=square of value in one variable Y^2=square of value in the other variable. XY=product of values of the two variables. N=number of cases compared and ∑=sum

EMPIRICAL RESULT

Test of hypotheses

The first hypothesis formulated for investigation and analysis in this study is concerned with assessing the extent, pre-mergers/acquisitions capital base of money deposit banks could increase corporate profitability. The hypothesis is stated in its null (Ho) as shown below:

H_{01}: There is no significance relationship between banks pre-mergers/acquisitions equity capital base and profitability.

The below test duly examined the influence of capital base on profitability of commercial banks. The result showed that capital base is insignificant in influencing the profitability of commercial banks as value of r^2 falls between 0.0 to 0.2is very low. We therefore accept null (H_0) hypothesis which says there is no positive relationship between capital base and profitability of commercial banks. We therefore reject alternative hypothesis (H_i).

Table 1: Significant relationship between banks' pre merger capital base and profitability

Bank	Ave. pre-merger capital base X ₦b	Ave. pre-merger profit after tax Y ₦b	X^2 ₦b	XY ₦b	Y^2 ₦b
Access Bank Plc	10	5	100	50	25
AfribankPlc	14	1	196	14	1
First City Mo. Bank Plc	7	0.60	49	4.2	0.36
First Bank Plc	44	13	1,936	572	169
Diamond Bank plc	5	0.13	25	0.65	0.02
Oceanic Bank Plc	15	3	225	45	9
Devcom/ETB Plc	4	0.69	16	2.76	0.48
IBTC Chartered Bank Plc	2	0.85	4	1.7	0.72
United Bank for African Plc	18	3	324	54	9
WEMA Bank Plc	13	1	169	13	1
Intercontinental Bank Plc	23	5	529	115	25
Bank PHB	11	2	121	22	4
Sterling Bank Plc	6	0.44	36	2.64	0.19
Fidelity Bank Plc	11	1	121	11	1
EcoBankPlc	12	1	144	12	1
Fidelity Bank Plc	36	8	1,296	288	64
Skye Bank plc	3	0.37	9	1.11	0.14
TOTAL	**$\sum x$=234**	**$\sum y$=46.08**	**$\sum x^2$=5,300**	**$\sum xy$=1,209.06**	**$\sum y^2$=310.91**

Sources: banks' published financial statement 2008.

$$b = \frac{(\sum xy) - (\sum y)(\sum x)}{n(\sum x^2) - (\sum x)^2} = \frac{17(1{,}209.06) - (46.08)(234)}{17(5{,}300) - (234)^2} = \frac{20{,}554.02 - 10{,}782.72}{90{,}100 - 54{,}756}$$

$$= \frac{9{,}771.3}{35{,}344} = \underline{\mathbf{0.276}}$$

$$a = \frac{\sum y}{n} - \frac{b\sum x}{n} = \frac{46.08}{17} - \frac{0.276(234)}{17} = \frac{46.08}{17} - \frac{64.58}{17} = \frac{46.08 - 64.58}{17} \frac{-18.5}{17} = =$$

<u>1.09</u>

Y= -1.09+0.276X

$$r = \frac{N(\sum xy) - \sum x \sum y}{\sqrt{\left[N(\sum x)^2 - (\sum X)^2\right]\left[N\sum Y^2 - (\sum y)^2\right]}}$$

$$r = \frac{17(15,272) - (1,298)(136)}{\sqrt{\left[17(134,346) - (134,346)^2\right]\left[17(2,469) - (2,469)\right]}} = \frac{2912}{\sqrt{(11,444)(1126)}}$$

$$= \frac{2912}{\sqrt{1288633944}} = \frac{2912}{11,352} =$$ **<u>0.2565</u>**

Test of hypothesis 2

Table 2: Relation between post- mergers and acquisition capital base and profitability of banks

Bank	Average post-merger capital base X ₦ Billion	Average Post merger profit after tax Y ₦ Billion	X^2 ₦ Billion	XY ₦ Billion	Y^2 ₦ Billion
Access Bank Plc	76	8	5,776	608	64
AfribankPlc	30	5	900	150	25
First City Mon. Bank	64	7	4,096	448	49
First Bank Plc	159	22	25,281	3,498	484
Diamond Bank plc	67	6	4,489	402	36
Oceanic Bank Plc	158	11	24,964	1,738	121
Devcom/ETB Plc	78	7	6,084	546	49
IBTC Chartered Bank Plc	33	5	1,089	165	25
United Bank for African Plc	136	25	18,496	3,400	625
WEMA Bank Plc	8	(21)	64	(168)	441
Intercontinental Bank Plc	136	8	18,496	1,088	64
Bank PHB	77	10	5,929	770	100
Sterling Bank Plc	27	1	729	27	1
Fidelity Bank Plc	64	7	4,096	448	49
EcoBankPlc	34	4	1,156	136	16

Fidelity Bank Plc	101	16	10,201	1,616	256
Skye Bank plc	50	8	2,500	400	64
TOTAL	$\sum$x=1,298	$\sum$y=136	$\sum x^2$=134,346	$\sum$xy=15,272	$\sum Y^2$=2,469

Source: banks' published financial statement, 2008

The second hypothesis formulated for investigation and analysis in this study is concerned with assessing the extent, post-mergers/acquisitions capital base of commercial banks could increase corporate profitability of commercial banks. The hypothesis is stated in its null (Ho) as shown below:

H_{02}: There is no significance relationship between banks post-merger/acquisition equity capital base and profitability.

$$b = n\frac{(\sum xy) - (\sum y)\ (\sum x)}{n(\sum x^2) - (\sum x)^2} \quad = \frac{17\,(15{,}272) - (136)\quad(1{,}298)}{17(134{,}346) - (1{,}298)^2}$$

$$= \frac{259{,}624 - 176{,}528}{2{,}283{,}882 - 1{,}684{,}804} \quad = \frac{83{,}096}{599{,}078} = \underline{\underline{\mathbf{0.139}}}$$

$$a = \frac{\sum y}{n} - b\frac{\sum x}{n} = \frac{136}{17} - \frac{0.139(1{,}298)}{17} = \frac{136}{17} - \frac{180.4}{17} = \frac{136 \quad - 180.4}{17} = -\frac{44.4}{17} = \underline{\underline{\mathbf{2.61}}}$$

Y = -2.61 + 0.139X

$$r = \frac{17[15{,}272] - [1.298][136]}{\sqrt{[17(134346) - (134346)\ ][17(2469) - 2469]}}$$

$$r \quad = \frac{259{,}624 - 176.528}{\sqrt{[2{,}283.882\ \ - 134{,}346][41{,}973 - 2.469]}} \qquad = \frac{83{,}096}{\sqrt{[2{,}149{,}536][39{,}504]}} \qquad =$$

$$\frac{83{,}096}{\sqrt{[84{,}915{,}270{,}144]}}$$

$$\frac{= 83.096}{291{,}402} = \qquad \mathbf{0.285}$$

The above test duly examined the influence of capital base on profitability of commercial banks. The result showed that capital base is insignificant in influencing the profitability of commercial banks as value of r^2 falls between 0.0 to 0.2 which shows very low (no relationship). We therefore accept null (Ho) hypothesis which says there is no positive relationship between capital base and profitability of commercial banks. We therefore reject alternative hypothesis (H1).

CONCLUSION AND POLICY IMPLICATIONS

From the analysis of related literature, analysis and interpretation of data, the study concludes that. Consolidation exercise through mergers and acquisitions has not improved the profitability performances of banks significantly. Equally important, is the fact that introduction of consolidation through merger and acquisition has brought about changes in ownership structure. It has brought about decentralization of ownership to many shareholders contrary to over centralization of ownership in the hand of few shareholders prior to mergers and acquisitions of money deposit banks in Nigeria. The study further shows that one of the fall outs of the mergers is the shrinkage in the industry from 89 to 22 banks (Okpugie *et al*. 2005.Nigeria has a mega banks with huge capital to invest, but it is instructive to note that size and huge capital does not necessarily make a good and sound bank. What makes a sound bank is really how effective and efficient the management of the bank is deploying the available resources. Generally, the study affirms that for a bank to survive in the current dispensation it needs to maximize its comparative advantage (strength), by promoting its uniqueness in the areas where it performs best. The decisive factors for competition and profitability in the new era would be the optimization of resources by the emerging mega banks .If any bank wishes to compete in the coming era, now is the time to plan for optimal resources structure, because the banks with the best brains and best hands would have an uncommon edge not only for future profitability but also survive future failure.

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